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EQUITY-INDEXED ANNUITIES DEMYSTIFIED

There is perhaps no financial product more confusing today than equity-index annuities or EIAs. On the surface, EIAs are somewhat simple. Like most annuities, EIAs are nothing more than a contract between you and an insurance company in which the company promises to make periodic payments or a lump-sum payment to you, starting immediately or at some future time, according to the NASD.

But EIAs are more complex than traditional fixed annuities or variable annuities. As with fixed annuities, they provide a guaranteed minimum return, typically 90 percent of the premium paid at a 3 percent annual interest rate. However, EIAs also typically provide a potential upside amount tied to an equity index, similar to variable annuities.

Herein lies much of the confusion. EIAs give you more risk but more potential return than fixed annuities but less risk and less potential return than variable annuities. How so? According to the Securities and Exchange Commission (SEC), EIAs work as follows: During the accumulation period – when you make either a lump-sum payment or a series of payments – the insurance company "credits" you with a return that is based on changes in an equity index, such as the S&P 500 Composite Stock Price Index, but not necessarily equal to the full total return of the index.

The variations in insurance company crediting procedures add much to the complexity of EIAs. These deviations from a uniform standard often contain several features that can affect your return. And you should fully understand how an EIA computes its index-linked crediting rate before you buy such a product. EIAs typically include one or several of the following three common features used to compute the return:

Participation Rates. The participation rate determines how much of the index's increase will be used to compute the index-linked interest rate. For example, if the participation rate is 90 percent and the index increases 5 percent, the return credited to your annuity would be 4.5 percent.

Crediting Rate Caps. Some EIAs set a maximum rate that the equity-indexed annuity can be credited in a year. If a contract has an upper limit, or cap, of 7 percent and the index linked to the annuity gained 7.2 percent, only 7 percent would be credited to the annuity.

Margin/Spread/Administrative Fee. The index-linked return for some EIAs is determined by subtracting a percentage from any gain in the index. This fee is sometimes called the "margin," "spread," or "administrative fee." In the case of an EIA with a "spread" of 3 percent, if the index gained 9 percent, the return credited to the annuity would be 6 percent (9 - 3 = 6).

Another feature that can affect an EIA's return is its "indexing method," which identifies how the amount of change in the relevant index is determined to calculate the crediting rate. According to the SEC and NASD, common indexing methods, which may apply annually or only at the end of a set number of years, include:

Point-to-Point. This method credits an index-linked return according to any increase in index value from the beginning to the end of the contract's term.

Monthly Averaging. This method determines the amount of return to credit based on the average value of the index over a period of months (typically calculated over 12-month periods, on the contract anniversary date).

High Water Mark. This method credits an index-linked return according to any increase in index value from the index level at the beginning of the contract's term to the highest index value at various points during the contract's term, often annual anniversaries of when the EIA was purchased.

EIAs can also be confusing because of other potentially pricey features. If you surrender your EIA early, you may have to pay a significant surrender charge to the insurance company, plus a 10 percent tax penalty on earnings to the IRS if you are below 59½ years of age. The SEC also says you can still lose money if your guarantee is based on an amount that's less than the full amount of your purchase payments. And, in some cases, the SEC says insurance companies may not credit you with index-linked interest if you do not hold your contract to maturity, foregoing all of your credited returns over the years to instead receive only the minimum guarantee.

In short, do your homework before you purchase an EIA. Understand how it works, what factors to consider in making your decision, and how you can avoid common problems. It may be possible, less expensive and less complicated to accomplish the same investment goal with a combination of a no-load equity index mutual funds and zero-coupon bonds.

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